(4)

No. 01-265

In The

Supreme Court of the United States

HOECHST CELANESE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of California

REPLY BRIEF FOR PETITIONER

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RULE 29.6 STATEMENT

Petitioner Hoechst Celanese Corporation changed its name to CNA Holdings, Inc., effective August 17, 1999. CNA Holdings, Inc. is a wholly-owned subsidiary of Celanese Americas Corporation, which is a wholly-owned subsidiary of Celanese A.G. Celanese A.G. is a publicly traded corporation. During the year in issue, 1985, Hoechst Celanese Corporation (formerly Celanese Corporation) was a publicly traded corporation, with no parent corporation, and no publicly held company owned 10% or more of Celanese's stock.

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REPLY BRIEF FOR PETITIONER

Respondent essentially makes four points in its Brief in Opposition. First, it contends the decision of the California Supreme Court is consistent with this Court's precedents. (Brief in Opposition to Petition for Writ of Certiorari ("Br. Opp.") 6-17.) Second, it contends the pension reversion was properly taxable by California as apportionable business income. (Br. Opp. 18-20.) Third, it contends the issue of how the operational test in *Allied-Signal, Inc. v. Director, N.J. Div. of Tax*, 504 U.S. 768 (1992), should be interpreted and applied is not ripe for resolution by this Court. (Br. Opp. 20-22.) Fourth, it contends the California Supreme Court's decision "presents at least as stringent an obstacle to apportionment for tax purposes as does *Allied-Signal*," and thus the decision below does not undermine constitutional restraints on state taxation. (Br. Opp. 6, 23.)

None of these points has merit. First, respondent's attempt to cast this case as consistent with this Court's precedents ignores the constitutional principles established by this Court. Rather than relying on the language in *Allied-Signal* for guidance on the meaning of the "operational" standard, the California Supreme Court relied on language from *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), a decision that preceded *Allied-Signal* by nearly ten years, where the issue was *not* how an asset was used in the taxpayer's business, but whether the taxpayer was engaged in a unitary business. This Court was clearly aware of its *Container Corp.* decision when it decided *Allied-Signal*, and this Court did *not* choose to use the language in *Container Corp.* as the standard in *Allied-Signal*. The California Supreme Court's decision to take language from *Container Corp.* out of context to create a new "operational" test, which is patently inconsistent with *Allied-Signal*, erroneously interprets and applies *Allied-Signal*.

Second, respondent's contention that the pension reversion was properly taxable by California as apportionable business income ignores the constitutional issue under *Allied-Signal*. The decision below allows a state to tax income because the "income producing asset" helped the taxpayer "make better use" of an important and existing business-related resource. To "make better use" of an "incoming producing asset" is *not* the constitutional standard under *Allied-Signal*.

Third, the issue of how the operational test in *Allied-Signal* should be interpreted and applied is ripe for resolution by this Court.

Fourth, respondent's claim the decision below will not seriously undermine constitutional restraints on state taxation disregards this Court's Due Process and Commerce Clause doctrines. The decision below poses a serious threat to constitutional restraints on state taxation by allowing a state to tax value earned outside its borders and to tax the income of a corporation having no minimum connection between the interstate activities and the taxing state.

I. THE CALIFORNIA SUPREME COURT'S "MAKE BETTER USE" TEST ERRONEOUSLY INTERPRETS AND MISAPPLIES THIS COURT'S PRECEDENTS

A. *Allied-Signal* and *Container Corp.* are Separate and Distinct Decisions by this Court

This Court, in *Allied-Signal*, established an operational test. This Court stated that "the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases," but "[w]hat is required instead is that the capital transaction serve an operational rather than an investment function." *Allied-Signal, supra*, 504 U.S. at 786-787. This is not the language or test used by this Court in *Container Corp.*

The language in *Container Corp.*, which the California Supreme Court cites as its "operational" definition under *Allied-Signal*, is taken out of context. Not only does *Container Corp.* precede *Allied-Signal* by nearly ten years, but the language used by the California Supreme Court from *Container Corp.* is in the context of the unitary business determination. One of the taxpayer's contentions in *Container Corp.* was that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. *Container Corp., supra*, 463 U.S. at 178. In responding to *this* argument by the taxpayer, this Court in *Container Corp.* stated:

> When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to *make better use* – either through economies of sale or through operational integration or sharing of expertise – *of the parent's existing business-related resources.*

Id. (emphasis added).

This language from *Container Corp.*, the only language looked to by the California Supreme Court on the "operational" issue, is clearly directed to the issue of unity, and specifically to the taxpayer's claim in that case that a state administrative presumption involving unity was invalid. This language from *Container Corp.* has *nothing whatsoever to do with the "operational" issue presented in Allied-Signal*, which is the issue presented by Celanese's pension reversion gain.

Respondent contends *Container Corp.* and *Allied-Signal* are "based on the same notion" (Br. Opp. 10), and thus the California Supreme Court's reliance on the language from *Container Corp.* is proper. This contention fails. If this Court intended to use the language of *Container Corp.* to articulate the operational standard in *Allied-Signal*,

then this Court would have used the same language from *Container Corp.* It did not. These two decisions involve two distinctly separate concepts – the unitary business principle and the taxability of nonunitary income.

B. The California Supreme Court's "Make Better Use" Test Suffers from the Same Flaws Pointed Out by this Court in Both *ASARCO* and *Allied-Signal*

The California Supreme Court adopted a standard indistinguishable from the standard this Court rejected in *ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307 (1982), and again in *Allied-Signal.* It does this by creating a "make better use" test for when an asset is "operational." Respondent's contention that this "make better use" test is consistent with *ASARCO* and *Allied-Signal* is without merit. (Br. Opp. 11-14.) The California Supreme Court's "make better use" test bears all the same flaws pointed out in *ASARCO,* and again in *Allied-Signal,* because pressed to its logical limit, it "becomes no limitation at all." *ASARCO,* 458 U.S. at 326. Respondent contends the California Supreme Court's "make better use" test relates to assets which contribute "to the production of 'business income,' " which is "different from the 'business purpose' standard" as rejected by this Court in *ASARCO.* (Br. Opp. 12.) Celanese disagrees.

This Court, in both *Allied-Signal* and *ASARCO,* rejected a "business purpose" standard. *Allied-Signal* stressed, as this Court had previously held in *ASARCO,* that "the fact that a transaction was undertaken for a *business purpose* does not change its character. [Citation omitted.] Idaho had argued [in *ASARCO*] that intangible income could be treated as earned in the course of a

unitary business if the intangible property which produced the income is 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " *Allied-Signal, supra,* 504 U.S. at 788-789 (quoting *ASARCO,* 458 U.S. at 326) (emphasis added). In rejecting this argument, this Court observed in *ASARCO*:

> This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business.' When pressed to its logical limit, this conception of the 'unitary business' limitation becomes no limitation at all.

ASARCO, 458 U.S. at 326 (emphasis added); *see also Allied-Signal, supra,* 504 U.S. at 789.

Quoting this language, this Court in *Allied-Signal* declared that apart from semantics, it saw no distinction between the "purpose" test rejected in *ASARCO* and an "ingrained acquisition-divestiture policy" adopted by the New Jersey Supreme Court in the lower court decision in *Allied-Signal. Allied-Signal, supra,* 504 U.S. at 789.

The constitutional analysis portion of the California Supreme Court's decision where it articulates the "make better use" test (App. 43a-45a) is not a "reference," as contended by respondent (Br. Opp. 13), to earlier (non-constitutional) portions of the California Supreme Court's opinion wherein it analyzed California's business income definition. If the California Supreme Court had intended the "make better use" test to only apply and refer to the context of "business income," then it would have said so in its opinion. It did not. The California Supreme Court has adopted a general standard, applicable to <u>any</u> asset

which helps the taxpayer "make better use" of its business-related resources, and this standard is indistinguishable from the "business purpose" standard which was rejected by this Court in both *ASARCO* and *Allied-Signal*.

C. The California Supreme Court's Definition of "Integral" as Used in the California Revenue and Taxation Code Has No Relation to the Federal Constitutional Issues Raised in this Petition

Respondent contends the California Supreme Court's analysis of whether California can constitutionally tax the pension reversion, which constitutes less than three pages of the opinion (App. 43a-45a), is contingent upon or relies on the discussion of the meaning of the word "integral" as defined in the California Revenue and Taxation Code. (Br. Opp. 15.) Celanese disagrees.

The California Supreme Court's discussion of "integral" as defined in California Revenue and Taxation Code section 25120 is just that, *i.e.*, a state court defining a term found in a state statute. Defining a term in a state statute is not the same as determining whether the application of that statute to Celanese violates the federal Constitution. The California statute in issue (section 25120) is part of the Uniform Division of Income for Tax Purposes Act (UDITPA). Cal. Rev. and Tax Code § 25120 *et seq.* Recall that *amici curiae* urged this Court in *Allied-Signal* "to adopt as the constitutional test the standard set forth in the business income definition . . . " in UDITPA, and this Court refused to do so. *Allied-Signal, supra,* 504 U.S. at 786. There can be no clearer indication that the "business income" standard in UDITPA and the "operational" standard in *Allied-Signal* are not the same.

II. FTB'S TAXATION OF THE PENSION REVERSION IS INCONSISTENT WITH *ALLIED-SIGNAL*

Taxation of the Celanese pension reversion because "the pension plan and trust undoubtedly helped Hoechst 'make better use' of an important and existing business-related resource – its employees" (App. 44a-45a), violates *Allied-Signal*. As discussed above, "making better use" of an asset is *not* the constitutional standard under *Allied-Signal*. The proper standard under *Allied-Signal* is whether the *capital transaction* served an *operational, rather than investment, function*.

Both the California Supreme Court and respondent err in stating it is the "income-producing asset," as opposed to the capital transaction, which must serve an operational function under *Allied-Signal*. (App. 44a; Br. Opp. 8-9.) The test articulated by this Court specifically states that "the *capital transaction* serve an operational rather than an investment function." *Allied-Signal, supra*, 504 U.S. at 787. The capital *transaction* in this case is *not* the pension plan. Rather, it is the *pension reversion* resulting from excess investment funds *not* needed to meet pension obligations, which did not serve an operational function.

Respondent contends that Celanese's "pension plan and fund are key elements of [its] compensatory system," and thus "the pension plan and fund were operationally related to Celanese's multi-state business operations." (Br. Opp. 18.) This fact is nowhere to be found in the record below. What is in the record below is that the pension reversion consisted of *excess* funds, *i.e.*, $388.8 million which represented trust assets in excess of liabilities. (Joint Stipulation ("Jt. Stip."), p. 6, ¶ 25.) In other words, the pension reversion investment income consisted entirely of funds *not* needed to maintain the pension

plan. The gain which resulted from the pension reversion was the result of investment gains in the pension plan which were above and beyond those funds needed to meet any needs of current and retired employees. (Chronological Index for the Original File of the Superior Court, pp. 194-195; *see also* Jt. Stip., pp. 5-6, ¶ 24.) It was the contributions to the plan, *not* the excess funds which were reverted, which provided for the retirement needs of current and retired employees. (Jt. Stip., pp. 5-6, ¶¶ 24-25.) This fact is evidenced by Celanese's continuing obligation to contribute $21 million to the pension plan in 1984 while working on the pension plan reversion, and at a time when Celanese *knew* the plan was overfunded and that the excess funds were going to be reverted. (Reporter's Transcript 98:1-9.) The excess funds in the pension fund which resulted in the pension reversion were not linked to Celanese "induc[ing] its employees to work," as claimed by respondent (Br. Opp. 18) because (1) the excess funds in the plan were not used or needed to meet employee pension needs; and (2) current and retired employees continued to receive unchanged benefits even after the termination of the plan and the reversion.

Respondent's reliance on *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999) is misplaced for two reasons. First, *Hughes* is not a state tax case, and it did not involve a pension reversion. *Hughes, supra*, 525 U.S. at 439 (stating "Hughes did not use the surplus for its own benefit."). *Hughes* is not relevant to the pension reversion issue in this case. *Hughes* involved a class action claiming Hughes had violated ERISA in terminating a plan and creating new plans. Second, *Hughes* does not stand for the proposition asserted by respondent and the California Supreme Court. Nowhere does *Hughes* state that the earnings or losses in a defined benefit plan affect the amount the

company must contribute to the plan, as claimed by respondent and the California Supreme Court. As noted above, Celanese contributed $21 million to the pension plan in 1984 and at a time when Celanese *knew* the plan was overfunded and that the excess funds were going to be reverted. Accordingly, respondent's contention that "earnings" from the pension fund served to reduce Celanese's "ongoing labor costs," and its conclusions drawn therefrom, are incorrect.

III. *ALLIED-SIGNAL* REMAINS IN CONTENTION AMONG THE STATES

Respondent disagrees with Celanese's claim that without this Court's immediate resolution of this issue, jurisdictions will continue to inconsistently interpret and apply *Allied-Signal*. (Br. Opp. 20.) The majority of respondent's discussion focuses upon distinguishing *Union Carbide v. Offerman*, 526 S.E.2d 167 (N.C. 2000), where under nearly identical facts, and interpreting a nearly identical statute to California's "business income" statute, the highest court of North Carolina held a pension reversion was *not* taxable by North Carolina. Celanese reiterates that absent intervention by this Court, *Allied-Signal* will be ignored by courts, such as the California Supreme Court, leading to inconsistent results such as that found between California in the present case and North Carolina in *Union Carbide*. In addition, while respondent correctly states that *Union Carbide* does not make any reference to *Hughes* (Br. Opp. 21-22), it is a distinction without legal significance. *Hughes* does not change the fact that the reversion in this case was caused by amounts in the pension plan above and beyond those funds needed to meet any needs of current and retired

employees. *Hughes* certainly does not stand for the proposition that excess funds reverted with the approval of the Pension Benefit Guarantee Corporation and the Internal Revenue Service are not "operational" under *Allied-Signal.*

IV. THE CALIFORNIA SUPREME COURT'S DECISION UNDERMINES CONSTITUTIONAL RESTRAINTS ON STATE TAXATION

To reiterate our position, the decision below stands for a proposition of astonishing breadth: A state may constitutionally apportion income of a corporation, in the complete absence of any unitary ties, so long as the capital transaction producing such income helps the corporation "make better use" of its business-related asset. Under California's definition of an operational function, in the opinion below, virtually all income from a capital transaction, passive investment or otherwise, will be considered operational so long as it has something to do with the business of the taxpayer. The impact of the California Supreme Court's decision is not merely theoretical. If the decision below stands, it will pave the way for every state to avoid the constitutional limitations on its taxing powers.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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